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Airline Focus: Using Section 1113 To Navigate Stormy Skies

Friday, Sep 15, 2006 --- The continuing financial malaise of U.S. air carriers has featured prominently in recent headlines, as airlines such as Northwest, Delta, Mesaba Aviation, Independence Air and Era Aviation all sought Chapter 11 protection in 2005 in an effort to manage a staggering confluence of nearly five years of lagging demand, high fuel prices and escalating labor costs.

A fair amount of scrutiny in connection with these developments has been devoted to the carriers' reliance on a Chapter 11 filing (or the threat of one) as a way to reduce unionized labor costs by taking advantage of a provision in the Bankruptcy Code that allows a Chapter 11 debtor-in-possession (DIP) or bankruptcy trustee to reject a collective bargaining agreement.

The bankruptcy court overseeing the Chapter 11 case of Delta subsidiary Comair recently had an opportunity to examine the circumstances under which a labor agreement can be rejected in a Chapter 11 case.

The court denied the rejection motion, at least initially, ruling that Comair failed to negotiate with the representative of its unionized flight attendants in good faith concerning proposed wage reductions.

* Collective Bargaining Agreements in Bankruptcy *

Section 365 of the Bankruptcy Code allows a bankruptcy trustee or DIP to assume (reinstate) or reject (breach and terminate) most kinds of contracts or agreements that, as of the bankruptcy filing date, are "executory" in the sense that both parties to the contract have a continuing obligation to perform.

For most kinds of contracts, the bankruptcy court will authorize assumption or rejection provided it is demonstrated that either course of action represents an exercise of sound business judgment.

Until 1984, courts struggled to determine whether the same standard or a more stringent one should govern a DIP's decision to reject a collective bargaining agreement.

The U.S. Supreme Court answered that question in 1984, ruling in NLRB v. Bildisco & Bildisco that a labor agreement can be rejected under Section 365 if it burdens the estate, the equities favor rejection and the debtor made reasonable efforts to negotiate a voluntary modification without any likelihood of producing a prompt satisfactory solution.

Congress changed that later the same year, when it enacted Section 1113 of the Bankruptcy Code in response to a groundswell of protest from labor interests. Section 1113 provides that the court “shall” approve an application to reject a bargaining agreement if:

the debtor makes a proposal to the authorized representative of the employees covered by the agreement;

the authorized representative has refused to accept the debtor's proposal without good cause; and

the balance of the equities clearly favors rejection of the agreement.

The provision ensures that a Chapter 11 debtor-employer cannot unilaterally rid itself of its labor obligations, and instead, mandates good faith negotiations with the union before rejection may be approved. To that end, Section 1113 carefully spells out guidelines for any proposal presented by the debtor to the authorized labor representative.

Underlying these guidelines is the premise that all parties must exercise their best efforts to negotiate in good faith to reach mutually satisfactory modifications to the bargaining agreement, and that any modification proposal treats all creditors, the debtor and other stakeholders parties fairly.

Each proposal must be based on the most complete and reliable information available and must “provide for those necessary modifications in the employees benefits and protections that are necessary to permit the reorganization of the debtor.”

* Split in Authority *

Courts are split on what modifications to a bargaining agreement qualify as “necessary” within the meaning of Section 1113.

In Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of America, the Third Circuit ruled that that the term “necessary” includes only those minimum modifications that the debtor “is constrained to accept because they are directly related to the company's financial condition and its reorganization,” in effect holding that the terms “necessary” and “essential” are synonymous.

Moreover, the Third Circuit ruled, in keeping with Section 1113's purpose, the objective of the modifications should be the short term “goal of preventing the debtor's liquidation.”

The Second Circuit rejected this approach in Truck Drivers Local 807 v. Carey Transportation Inc.

There, the Court of Appeals held that, in determining the degree and purpose of "necessary" modifications, "the necessity requirement places on the debtor the burden of proving that its proposal is made in good faith, and that it contains necessary, but not absolutely minimum, changes that will enable the debtor to complete the reorganization process successfully."

In adopting this approach, the court focused on the long-term goal of reorganization, rather than the short-term goal of preventing liquidation. A majority of courts have adopted the more flexible approach articulated in Carey Transportation.

Section 1113's requirements regarding the provision of adequate information and the obligation to negotiate in good faith were recently examined by the New York bankruptcy court overseeing Comair's Chapter 11 case.

* Comair *

Comair, its parent company Delta Air Lines Inc., and various affiliates filed for Chapter 11 protection in September of 2005. Comair is a regional air carrier operating on average 800 flights each day between Cincinnati, New York, Boston and Washington D.C. as part of the Delta Connection program, which also includes five other regional carriers. Comair has approximately 6,400 employees, of whom roughly half are unionized pilots, maintenance workers and flight attendants.

The work rules, wages and benefits of these employee groups are governed by three separate collective bargaining agreements. The authorized bargaining representative of the flight attendants is the International Brotherhood of Teamsters (IBT).

Flight attendants are at or near the low end of the compensation level for all Comair employees, with wages ranging from an average of $16.50 per hour and $21.70 per hour for "B scale" and "A scale" first-year flight attendants to just over $42 per hour for attendants with 18 years or more of seniority. Flight attendants are also paid an hourly expense allowance of $1.75 (referred to as a per diem) for every hour that an attendant is away from base on assigned trips.

As part of Delta's restructuring plan, Delta reduced by approximately 3.8% the amount it pays to Comair under the Delta Connection program. Because Delta is Comair's only source of revenue, this meant that Comair had to make a corresponding reduction as part of its own restructuring plan.

Comair's plan called for reductions totaling $27.2 million in annual collective bargaining agreement costs, of which $17.3 were allocated to pilots, $8.9 million were allocated to flight attendants and $1 million were allocated to mechanics. The flight attendants' portion of the cuts included reductions of $6.8 million in wages and $2.1 million in per diem payments as well as the elimination of funding for a retirement program.

The pilots and mechanics agreed to the cuts, subject to contingency clauses invalidating their approval unless all unionized groups agreed to the package of reductions. The flight attendants, however, did not ratify the reductions despite a series of bargaining sessions and proposals between Comair and IBT.

During the course of these negotiations, Comair refused to negotiate its original demand for $8.9 million in aggregate cost reductions from flight attendants, although it was willing to vary the mix of cost savings among pay rates, per diems, work rules and other costs.

By contrast, IBT's counter-proposal would achieve approximately $1.89 million in cost savings, or approximately 25% of the amount originally allocated by Comair to the flight attendants.

Comair moved to reject the flight attendant's bargaining agreement under Section 1113. The bankruptcy court segmented its examination of the standards governing rejection into five parts: (i) whether the modifications proposed by Comair are necessary to permit reorganization; (ii) whether Comair conferred with IBT in good faith; (iii) whether Comair's proposal assures that all parties are treated fairly and equitably; (iv) whether IBT refused to accept the proposal without good cause; and (v) whether the balance of the equities clearly favors rejection of the bargaining agreement.

In four out of five of these categories, the court concluded, Comair's request to reject the flight attendants' agreement was deficient.

The court rejected IBT's contention that the proposed cuts were not "necessary" for Comair to reorganize because Comair "is a healthy, viable, regional operation" and cost cuts already agreed to by other unions made it unnecessary for the flight attendants to make additional concessions to the extent requested by Comair.

Applying the Second Circuit's definition in Carey Transportation of "necessary," the bankruptcy court characterized IBT's assertions regarding Comair's financial health as "contrary to the unrebutted evidence."

It then proceeded to discredit IBT's "last man standing" argument, explaining that the proposal called for by Section 1113 must not only be necessary, but must also assure that all affected parties "are treated fairly and equitably." According to the bankruptcy court, Section 1113 "does not contemplate that any single group of employees such as the flight attendants will be subsidized by the sacrifices of others."

The bankruptcy also concluded that Comair had not fulfilled its obligation to confer with IBT in good faith by steadfastly maintaining that its initial proposal was non-negotiable. True negotiation, the court observed, "necessarily requires compromise in each side's bargaining positions."

It rejected Comair's argument that the contingency clauses in agreements reached with the other unions render Comair's proposal non-negotiable because at stake is not merely the $8.9 million demanded from the flight attendants, but the entire $27.2 million required from all three unions.

Explaining that Section 1113 demands that each proposal be judged according to the statutory criteria on its own merits, the bankruptcy emphasized that “the tacit consequences” of Comair’s arguments predicated on the contingency clauses would be to usurp the court’s function in judging the sufficiency of Comair’s proposal to IBT.

Next, the bankruptcy court ruled that Comair’s proposal to IBT failed to pass muster under Section 1113’s “fair and equitable” requirement because Comair’s non-negotiable demand called for flight attendants, who were already near the bottom level of compensation among Comair employees, to contribute twice their pro rata share of the cost cuts, while pilots and mechanics were asked for less than their proportionate shares.

Given all of the foregoing, the bankruptcy court explained, IBT’s refusal to accept Comair’s proposal was not without good cause.

Finally, the court inquired whether “the balance of the equities clearly favors rejection” of the flight attendants collective bargaining agreement.

The court acknowledged that Comair’s flight attendants’ salary and per diem rates are substantially higher than the rates of flight attendants employed by other U.S. regional carriers, and that Comair had made a “persuasive showing” that narrowing the gap between its own labor costs and the labor costs of its competitors would play an important role in Comair’s ultimate success or failure as a reorganized entity.

Even so, the bankruptcy court emphasized, based upon the other deficiencies in Comair’s proposal, the balance of the equities does not clearly favor rejection. The court accordingly denied Comair’s motion to reject its collective bargaining agreement with the flight attendants, without prejudice to its renewal after further negotiations.

* Outlook *

The quandary faced by Comair and its employees is emblematic of the grim reality that all carriers have been forced to confront in their ongoing efforts to regain profitability.
There have been 162 airline bankruptcy filings since the government deregulated commercial aviation in 1978. Collectively, the industry has lost nearly $28 billion since 2001 and is projected to lose another $3 billion in 2006.

The bleeding continues despite $7.4 billion in financial assistance from the federal government and $1.6 billion in loan guarantees to help commercial airlines recover from the effects of the September 11, 2001 terrorist attacks.

Only low-cost carrier Southwest Airlines has been consistently profitable over the past few years, thanks in part to its ability to hedge fuel contracts successfully.

Airlines intent upon cost cutting cannot help but take a hard look at labor costs—wages and related benefits are one of the few line items over which they have any direct control. In most cases, this means that the carriers will need to renegotiate the terms of their collective bargaining agreements with unionized employees, either outside of bankruptcy or in Chapter 11. As indicated by Comair, carriers faced with an impasse in effectuating “necessary” reductions will seek relief under Chapter 11 and Section 1113.

Delta Airlines sought to reject the collective bargaining agreement with its pilots in 2005. UAL Corporation also tried to reject labor agreements with its unionized pilots and flight attendants, but withdrew both motions after reaching a settlement with pilots concerning modification of the agreement to allow UAL to terminate the pilots’ pension plan, and after reaching a settlement with the Pension Benefit Guaranty Corporation (“PBGC”) regarding the latter’s consideration of a possible distressed termination of the flight attendants’ defined benefit pension plan (which ultimately occurred).

The bankruptcy court overseeing Northwest Airlines’ Chapter 11 case granted the carrier’s request to reject a collective bargaining agreement with its flight attendants on June 29, 2006, but stayed implementation of the order for two weeks to allow the parties to continue negotiating a voluntary compromise, failing which cuts proposed by Northwest to the Professional Flight Attendants Association at the beginning of March 2006 will take effect.

Comair is not the only airline debtor whose efforts to reject a labor agreement have failed to pass muster under Section 1113, at least on the first attempt.

A Minnesota bankruptcy court recently denied regional carrier Mesaba Aviation’s motion to reject collective bargaining agreements with its unionized pilots, mechanics and flight attendants based upon the court’s findings that the debtor refused to provide adequate information to the unions’ bargaining representatives, even though the court concluded that the cost reductions proposed by the debtor were necessary to its reorganization.

The bad news for employees in these developments is that some degree of wage and cost cuts is unavoidable if the airlines are to keep flying.

In fact, when again stonewalled by the unions after revising their cost reduction proposals, both Comair and Mesaba Aviation went back to the bankruptcy court seeking authority to reject their bargaining agreements under Section 1113. Both were successful on the second attempt.

Much more is at stake for the carriers, their employees and U.S. taxpayers than the airline wage scale. The driving motivation in many cases for rejecting a collective bargaining agreement concerns not only wages, but pension benefits that are incorporated into the contracts.

By rejecting a bargaining agreement under Section 1113, an airline can proceed to disavow its underfunded pension liability by effectuating a distressed termination of its pension plans.

Delta Air Lines did just that on September 5, 2006, when it won bankruptcy court approval to terminate its pilots' pension plan, which will allow the carrier to avoid paying the approximately $2.5 billion that is necessary to fund the plan fully.

When an airline or any other company terminates its pension plans, the PBGC gets stuck with the pension obligations. Since 1991, the government insurer has assumed nearly $12 billion in airline pension obligations.

With an aggregate deficit of nearly $23 billion as of the end of 2005, the PBGC needs help, and Congress recently cobbled together yet another aid package designed to stanch the flow of PBGC assets.

President George W. Bush gave his imprimatur on August 17, 2006 to the most sweeping pension reform in 30 years. Among other things, the Pension Protection Act of 2006 includes provisions that:

require employers to make sufficient contributions to their single-employer defined-benefit pension plans over the next seven years to achieve 100% funding;

prohibit employers and unions from increasing pension benefits from single-employer plans that are less than 80% funded, unless the additional benefits are paid for immediately;

require employers that terminate a pension plan in bankruptcy to pay $2,500 per participant upon exiting from bankruptcy; and

allow airlines that freeze all benefit accruals in their pension plans an additional ten years to meet their funding obligations, while allowing airlines that freeze new plan participants but allow current participants to accrue new benefits three additional years to meet their funding obligations.

According to some commentators, the reforms are unlikely to restore PBGC to solvency, but they may improve the embattled insurer's financial outlook, at least in the short term.

As more and more employers make the transition away from defined benefit plans because of stricter funding requirements, PBGC's premium base may actually diminish in the long run.

Moreover, the rules governing pension plan funding are not the only factors influencing PBGC's troubled financial condition—legislation can do little to stave off major business failures that are inevitable in a volatile economy.

Comair also illustrates the challenges faced by bankruptcy courts called upon to apply the standards set forth in Section 1113.

Section 1113 provides the court with a high level of discretion in making several subjective determinations. These include deciding what changes are “necessary” to a reorganization, assessing whether the debtor has conferred with union representatives in “good faith,” deciding whether a proposal has been rejected “without good cause” and ensuring that the “balance of the equities clearly favors rejection” of a labor agreement.

Making these determinations demands an exhaustive factual inquiry into not only the course of dealings between the debtor and union representatives, but also the debtor’s financial condition and proposed restructuring plan—an inquiry that bankruptcy courts are ordinarily called upon to perform in connection with plan confirmation proceedings at the final stages of a Chapter 11 case.

Bankruptcy reforms enacted in 2005 did nothing to ease the substantial burden borne by bankruptcy courts in applying Section 1113.

Moreover, a bill introduced in April of 2006—the Fairness and Accountability in Reorganization Act of 2006—would add an additional layer of inquiry to Section 1113 by requiring that, in considering a proposal made to an authorized representative of employees covered by a collective bargaining agreement, the court must take into account the ongoing impact on the debtor of its relationships with debtor and non-debtor affiliates, domestic or otherwise.

In re Delta Air Lines, 342 B.R. 685 (Bankr. S.D.N.Y. 2006).

In re Mesaba Aviation Inc., 341 B.R. 693 (Bankr. D. Minn. 2006).

In re Delta Air Lines, 2006 WL 2567757 (Bankr. S.D.N.Y. July 21, 2006).

In re Mesaba Aviation Inc., No. BKY 05-39258 (Bankr. D. Minn. July 14, 2006) (unpublished order).

NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984).

Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of America, 791 F.2d 1074 (3d Cir. 1986).

Truck Drivers Local 807 v. Carey Transportation Inc., 816 F.2d 82 (2d Cir. 1987).

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